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SUBJECT: HOUSING MARKET SLUMP CONTINUES

REF: A. MADRID 525
[1](#)B. MADRID 499
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[1](#)1. (SBU) Summary. Spain's housing market slowdown was long predicted but is proving more severe than most local analysts had anticipated. An oversupply of newly-built properties coupled with decreased demand has resulted in a glut of unsold homes. Because of this, real estate developers are finding it difficult to pay back their loans, construction activity has sharply decreased, and unemployment has significantly increased. The local media has emphasized the severity of this downturn, referring to the situation as a crisis and implying drastic effects on the broader economy. GOS officials and banking industry representatives are more optimistic and have said that they still expect a soft landing for the economy as a whole with an end to the downturn by 2010. Despite this optimism, a key question will be how successful Spain's economy is in generating sustainable growth, investment and jobs outside the residential construction sector. End Summary.

Downturn Worse than Predicted?

2.(SBU) Following a 10-year boom, Spain's residential real estate market is experiencing a downturn brought on by high prices, oversupply and decreasing demand. According to housing analysts at the Spanish Savings Bank Association (CECA), from 2004 to 2007, housing starts averaged an unsustainable rate of 600,000-700,000 per year (more than Germany, the UK, and France combined), and prices rose rapidly. During this period, a rate closer to 400,000 was justified by Spain's demographics -- even after taking into account immigration and second home purchases by foreigners. In the end, Spain was due for a correction, particularly as property purchases by foreigners tapered off. (Comment: Although CECA analysts did not mention it, significant interest rate increases between mid-2005 and mid-2007 may have contributed to the end of the boom as well. End Comment.)

3.(U) The excess supply has been compounded by a decreasing volume of home sales beginning in 2007. In the fourth quarter of 2007, sales were down by over 20% from the fourth quarter of 2006, according to GOS statistics. Even after sales started to decline, builders continued to complete and bring to market the many homes that had been started at the height of the boom. This aggravated the glut of properties, which some experts currently estimate at upwards of 600,000 unsold new homes.

[1](#)4. (U) As a result of the glut of unsold properties, real estate developers are experiencing difficulty paying back their loans. International credit market difficulties have aggravated these financing problems. Prominent Spanish construction companies and developers such as Llanera,

Ereaga, Contsa, SEOP, and a number of others have filed for bankruptcy, citing the inability to meet billions of euros worth of short-term debt obligations. Others have managed to renegotiate the terms of their loans in the short term.

¶15. (SBU) Because developers and construction companies have reduced their residential construction activity, many workers in construction and related business have been left without employment. Although increased unemployment was expected, the increase is proving to be worse than anticipated. National Institute for Statistics (INE) 2008 first-quarter data show construction-related job losses of over 400,000 from the previous quarter. In addition to construction sector job losses, the services sector was also seriously affected. Spain's overall unemployment rate increased from 8.0% in the third quarter of 2007 to 9.6% in the first quarter of 2008. The current total number of unemployed workers is slightly over 2.3 million, and a March 2008 KPMG study now predicts that the sector freeze may destroy up to 1.2 million jobs in the next two years.

GOS Officials Still Predict Soft Landing For Economy

¶16. (SBU) While Spanish officials acknowledge that the downturn has been more abrupt than anticipated, in general they continue to maintain that the economic situation is stable and headed for a soft landing. Second Vice President and Economy and Finance Minister Pedro Solbes asserted at a May 7 legislative hearing that while the economic adjustment was more rapid than anticipated, the downturn would end by

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the second half of 2009 with a return to 3% GDP growth in ¶2010. Other Spanish officials have espoused similar messages to us in private.

¶17. (SBU) A Ministry of Housing advisor recently told us that she and her ministry were confident that Spain would be able to successfully weather the adjustment. She asserted that the services sector would absorb the newly unemployed and that government public works programs to stimulate other types of construction would cushion the blow. (Comment: Other officials have indicated that public works spending already is high and is not likely to be increased dramatically. End comment.) Furthermore, the GOS would increase its stock of subsidized homes for low-income families to help real estate companies offload unsold properties.

¶18. (SBU) The advisor also highlighted characteristics of Spain's housing market that she argued would prevent the overall economic adjustment from becoming overly serious. For example, despite increases in inflation and interest rates, Spanish homeowners are still paying their mortgages and have very low delinquency rates compared with other EU countries. She noted that average home down payments in Spain are 20 percent of the value of the property, meaning that homeowners in Spain have more equity in their homes and thus higher incentives to avoid defaulting. Typical mortgages in Spain are 25-30 year adjustable rate mortgages tied to the Euribor interest rate.

¶19. (SBU) Staff from the Spanish Savings Bank Association (CECA) also told post that they were continuing to predict a soft landing for the economy as a whole. They called the housing downturn a short-term market correction that would reach equilibrium by 2010. They said that the glut of properties was in some ways an inevitable phenomenon, reaching its peak as Spain's 1960s baby-boomers completed their property purchasing cycle. When asked about the effect on the financial sector of the high number of real estate developers and construction companies declaring bankruptcy, one analyst said that Spanish banks were well-equipped to deal with high levels of bad loans given the Bank of Spain's

conservative policies on reserve requirements.

Comment

¶10. (SBU) While on the surface GOS and financial sector representatives appear calm, the Spanish media continues to portray a grim picture of the residential construction situation. Opposition Popular Party representatives have harshly criticized Spanish officials and accused them of neglect and complacency and of a failure to confront the crisis. News about real estate developers or construction companies facing financial difficulties or other negative economic indicators is a daily occurrence and draws a sharp contrast with GOS assurances. Although there likely is less urgent political concern within the GOS now that the March 9 election has passed, there seems to be some disagreement on appropriate steps. Vice President/Minister Solbes has said that the GOS should not try to impede "artificially" the necessary adjustment in the construction sector, and he has rejected a Housing Ministry proposal to provide tax incentives for residential improvements. Still, the news in construction is expected to get worse before it gets better, and the GOS is likely to feel pressure to address the sector's problems somehow.

¶11. (SBU) Despite assurances from GOS officials, a critical issue is how Spain's economy will make the transition away from the residential construction sector, which recently accounted for up to 9 percent of Spain's GDP. Many newly unemployed workers from the construction sector have low skill sets not easily adaptable to other sectors. Labor and Housing Ministry officials have told us in the past that this population, many of whom are immigrants, will make the shift with the help of GOS initiatives to increase job training opportunities. Bank economists also have been optimistic about the ability of the services sector to absorb many of the unemployed. The extent to which this takes place will be crucial, as it appears that construction will not return to its former level for the foreseeable future.

Llorens